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UNCLAS SECTION 01 OF 03 MADRID 000794

SENSITIVE  
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STATE FOR EUR/WE, EEB/IDF/OFD, AND EEB/CBA  
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TAGS: [EINV](#) [EFIN](#) [ECON](#) [PGOV](#) [PREL](#) [SP](#)  
SUBJECT: GUIDANCE REQUEST ON TAX INTERPRETATION ISSUE AFFECTING  
FOREIGN MULTINATIONAL COMPANIES

SENSITIVE BUT UNCLASSIFIED - PLEASE PROTECT ACCORDINGLY

11. (U) This is an action request. Please see paras 2 and 13.

12. (SBU) Summary and action requests: Post has received requests for assistance in regard to what appears to be a change in GOS interpretation of tax incentives for foreign-owned multinational holding companies based in Spain. Such holding companies have been deducting interest on loans taken out for foreign acquisitions, but in recent years the Spanish tax authority has been disallowing many deductions on the grounds of "abuse of law" constituting alleged tax avoidance. A number of U.S. companies have undergone lengthy tax inspections leading to hefty assessments which they are now challenging in administrative courts. Businesses say they face significant contingent liabilities and a climate of ambiguity and uncertainty. At least one firm argues that the practice discriminates against foreign companies (others disagree) and conflicts with the U.S.-Spain double taxation treaty. Post requests guidance in responding to the requests for assistance and to the argument that GOS practice conflicts with the double taxation treaty. End Summary and action requests.

#### Requests for Help

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13. (SBU) Post was approached earlier this year by the American Business Council (ABC) and AmCham Spain concerning the Spanish government's tax treatment of foreign-owned multinational holding companies based in Spain (Companies Holding Foreign Assets, or Entidades de Tenencia de Valores Extranjeros, ETVEs). This issue was prominent in the press a few years ago and was raised then by the AmCham, but we are not aware that post or the USG ever decided to take any action at that time. We have met with several companies to gain a better understanding of the issue before seeking guidance.

#### Incentives Enacted...

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14. In the late 1990s, in an effort to attract foreign-owned multinationals to establish holding companies in Spain, the Spanish Congress passed a series of measures that created a very friendly regime for such companies. Holding companies based in Spain could deduct the interest on loans taken out to purchase companies (or shares in companies) outside of Spain, and dividends and capital gains of such foreign subsidiaries were exempted from Spanish taxes. A holding company in Spain could write loan interest on foreign acquisitions off against income on its operations in Spain, resulting in significant tax advantages. These provisions were deemed possible in part because Spain has double taxation treaties with the U.S. and most European countries. In response to the new rules, a number of U.S. companies, as well as numerous European companies, set up holding companies in Spain to consolidate their

foreign operations. According to one source, the ETVEs regime enabled Spain to attract more than 100 billion euros in foreign capital between 2000 and 2005.

#### GOS Disallows Firms' Use of Incentives

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15. (SBU) However, beginning in about 2006, the Spanish Ministry of Economy and Finance and its tax authority, the State Agency for Tax Administration (AEAT), began questioning the tax returns of foreign-based multinationals. Not long thereafter, AEAT's Inspections division initiated a series of lengthy tax inspections which resulted in hefty assessments for a number of companies. Many foreign multinationals saw their books inspected for the period 2004-6 and many of their deductions disallowed, resulting in large tax bills. The companies also anticipate more inspections for more recent years. The tax authorities claim that many foreign-based holding companies were conducting financial activity purely within the same group that did not show any underlying economic rationale or real business purpose and thus constituted an "abuse of the law," an action that, while technically consistent with the letter of the law, was contrary to its spirit or philosophy.

16. (SBU) Business representatives and some private tax experts argue that while there may have been some instances where holding companies in Spain conducted transactions within the same group for the purpose of tax avoidance, tax authorities are disallowing deductions on all such internal operations regardless of whether there may be a legitimate business reason for them. There may be as many as 300 foreign-based multinationals that have conducted the sort of financial operations for which deductions are now being disallowed, in part because some professional business and tax consultants were advising prospective investors of the tax

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advantages of conducting operations from a Spanish-based holding company, and many companies followed their advice. It also bears repeating that the Spanish government's purpose in enacting the legislation was precisely to attract foreign-owned multinationals to set up shop in Spain.

17. (SBU) In assessing unpaid taxes, authorities have refused to negotiate or discuss settlement, considering it a matter of principle to collect in full. A number of foreign-owned multinationals, estimated at 25-30 so far (though there may be more), have been found to owe back taxes. In addition to significant contingent liabilities, such companies are required to post bond while appealing the tax agency's assessment. They also, uncomfortably, find themselves in an adversarial relationship with the tax authorities. Affected companies have appealed to the Central Economic Administrative Tribunals (Tribunal Economico Administrativo Central - TEAC); most cases are still pending, though one or two have been decided in favor of the government. Since the TEACs are part of the Ministry of Economy and Finance, companies expect that they will rule for the government in most cases. Companies that lose in the TEAC have the option of appealing to the independent judiciary, specifically the National Court (Audiencia Nacional). There is at least one case - involving a Swiss, not a U.S., company - that lost in the TEAC and has appealed to the Audiencia Nacional, but the process is very lengthy and could take 3-4 years. A party that loses in the Audiencia Nacional has the option of appealing to the Supreme Court, an even lengthier process. Among the U.S. companies affected are Pepsico, Exxon Mobil, Chevron, GE, HP, and General Mills.

#### Criticism from Business Groups

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18. (SBU) Groups representing foreign investors have criticized the Ministry and the tax authority for their actions. These investors assert that if the government does not like the consequences of the law as written (e.g., loss of significant tax revenues), it should change the law rather than engaging in dubious and expansive interpretations. They point out that other EU countries have legislated to eliminate tax loopholes and benefits that are determined to be too generous to business, but Spain has not.

19. (SBU) The National Foreign Trade Council, a Washington-based

association of some 300 U.S. business enterprises engaged in all aspects of international trade and investment, sent a letter in June 2008 to the Secretary of State (Vice Minister equivalent) for Finance, Carlos Ocana, outlining the problem and urging the government either to abide by the law's provisions as written or to amend the law. However, experts believe the GOS is reluctant to amend the law because a) this would be seen as an admission that the holding companies were in compliance and that it was the government that was misinterpreting the law; and b) any new law would not be retroactive and the government might thus have to "grandfather" in companies that set up holdings based on the current law.

¶10. (SBU) Based on the inspections that have taken place, foreign-owned multinationals are now on notice that the government will not allow write-offs for a range of activity conducted within a group, despite the language of the law. In addition, word has now spread among the foreign investor community to avoid setting up holding companies in Spain because of this issue. Foreign holding company investment has declined sharply in recent years. However, numerous companies, including the U.S. companies mentioned above, have several years' worth of disallowed deductions resulting in large and unexpected tax bills, and there will be more of the same as authorities continue to conduct tax inspections applying the same criteria.

#### Swiss Leading the Charge

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¶11. (SBU) The law firm of Baker & McKenzie (incorporated in Switzerland), which advises several U.S. companies, has been the most aggressive advocate on this issue. The Swiss Embassy has also been active, as several of the most seriously affected companies are Swiss-owned, and has encouraged post to weigh in with the GOS. Other Embassies have not played a prominent role, though multinationals from a several European countries are affected.

¶12. (SBU) When a Baker & McKenzie attorney raised the issue with State Secretary for Finance Ocana at an ABC-hosted breakfast, Ocana replied that the law is clear enough and does not need modification. In addition to the assertions of ambiguity, uncertainty, and unfounded interpretation, Baker & McKenzie argues that the government's approach also discriminates against foreign companies in that few if any Spanish (as opposed to foreign-based) holding companies have been inspected and any that have, have not had their

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deductions disallowed. They assert further that such discriminatory practice conflicts with Spain's obligations under the U.S.-Spain Double Taxation Treaty, and suggest that one possible solution would be for the USG to invoke the Mutual Agreement Procedure found in Article 26 of that Treaty and request government-to-government negotiations. Other tax experts state that the impact of the government's interpretation of the law falls on foreign-owned (but not Spanish) holding companies because Spanish holding companies are structured differently and do not engage in the kind of operations within the group that the tax authorities are disallowing. Under this theory, the effect, but not necessarily the intention, of the Spanish government's action would be considered disadvantageous to foreign-based multinationals.

¶13. (SBU) Post requests guidance in responding to the requests for assistance and to the argument that GOS practice conflicts with the double taxation treaty.

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